



# Foreign Investment and National Security: Economic Considerations

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December 1, 2008

Congressional Research Service

7-5700

[www.crs.gov](http://www.crs.gov)

RL34561

Report Documentation Page				Form Approved OMB No. 0704-0188	
Public reporting burden for the collection of information is estimated to average 1 hour per response, including the time for reviewing instructions, searching existing data sources, gathering and maintaining the data needed, and completing and reviewing the collection of information. Send comments regarding this burden estimate or any other aspect of this collection of information, including suggestions for reducing this burden, to Washington Headquarters Services, Directorate for Information Operations and Reports, 1215 Jefferson Davis Highway, Suite 1204, Arlington VA 22202-4302. Respondents should be aware that notwithstanding any other provision of law, no person shall be subject to a penalty for failing to comply with a collection of information if it does not display a currently valid OMB control number.					
1. REPORT DATE <b>01 DEC 2008</b>		2. REPORT TYPE		3. DATES COVERED <b>00-00-2008 to 00-00-2008</b>	
4. TITLE AND SUBTITLE <b>Foreign Investment and National Security: Economic Considerations</b>				5a. CONTRACT NUMBER	
				5b. GRANT NUMBER	
				5c. PROGRAM ELEMENT NUMBER	
6. AUTHOR(S)				5d. PROJECT NUMBER	
				5e. TASK NUMBER	
				5f. WORK UNIT NUMBER	
7. PERFORMING ORGANIZATION NAME(S) AND ADDRESS(ES) <b>Congressional Research Service, The Library of Congress, 101 Independence Avenue SE, Washington, DC, 20540-7500</b>				8. PERFORMING ORGANIZATION REPORT NUMBER	
9. SPONSORING/MONITORING AGENCY NAME(S) AND ADDRESS(ES)				10. SPONSOR/MONITOR'S ACRONYM(S)	
				11. SPONSOR/MONITOR'S REPORT NUMBER(S)	
12. DISTRIBUTION/AVAILABILITY STATEMENT <b>Approved for public release; distribution unlimited</b>					
13. SUPPLEMENTARY NOTES					
14. ABSTRACT					
15. SUBJECT TERMS					
16. SECURITY CLASSIFICATION OF:			17. LIMITATION OF ABSTRACT <b>Same as Report (SAR)</b>	18. NUMBER OF PAGES <b>26</b>	19a. NAME OF RESPONSIBLE PERSON
a. REPORT <b>unclassified</b>	b. ABSTRACT <b>unclassified</b>	c. THIS PAGE <b>unclassified</b>			

## Summary

The United States is the largest foreign direct investor in the world and also the largest recipient of foreign direct investment. This dual role means that globalization, or the spread of economic activity by firms across national borders, has become a prominent feature of the U.S. economy and that through direct investment the U.S. economy has become highly enmeshed with the broader global economy. This also means that the United States has important economic, political, and social interests at stake in the development of international policies regarding direct investment. With some exceptions for national security, the United States has established domestic policies that treat foreign investors no less favorably than U.S. firms.

The terrorist attacks on the United States on September 11, 2001, spurred some Members of Congress and others to call for a reexamination of elements of the traditionally open environment in the United States for foreign investment. In particular, some Members argue that greater consideration must be given to the long-term impact of foreign direct investment on the structure and the industrial capacity of the economy and on the ability of the economy to meet the needs of U.S. defense and security interests. In addition, policymakers from a broad group of nations are evaluating their national policies concerning foreign investment within the context of their national security concerns. As a result of these initiatives, Members of Congress may be pressed to address U.S. policies that focus on the role of foreign direct investment more extensively within a broader national security framework.

This report assesses recent international developments as the leaders from a number of nations work to reach a consensus on an informal set of best practices regarding national restrictions on foreign investment for national security purposes. This report also provides one possible approach for assessing the costs and benefits involved in using national policies to direct or to restrict foreign direct investment for national security reasons. Within the United States, there is no consensus yet among Members of Congress or between the Congress and the Administration over a working set of parameters that establishes a functional definition of the national economic security implications of foreign direct investment. In part, this issue reflects differing assessments of the economic impact of foreign investment on the U.S. economy and differing political and philosophical convictions among Members and between the Congress and the Administration.

This report will be updated as events warrant.

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## Overview

For more than half a century, the United States has led international efforts to reduce restrictions on foreign investment. In part, these efforts are related to a general commitment to open markets and to the free flow of international capital as an important component in economic development. At the same time, the United States is the largest foreign direct investor in the world and also the largest recipient of foreign direct investment. By year-end 2007, foreign direct investment in the United States had reached \$2.1 trillion and U.S. direct investment abroad had reached \$2.8 trillion. This dual role means that globalization, or the spread of economic activity by firms across national borders, has become a prominent feature of the U.S. economy and that through direct investment the U.S. economy has become highly enmeshed with the broader global economy.

The globalization of the economy also means that the United States has important economic, political, and social interests at stake in the development of international policies regarding direct investment. With some exceptions for national security,<sup>1</sup> the United States has established domestic policies that treat foreign investors no less favorably than U.S. firms. In addition, the United States has led efforts over the past 50 years to negotiate internationally for reduced restrictions on foreign direct investment, for greater controls over incentives offered to foreign investors, and for equal treatment under law of foreign and domestic investors.

In light of the terrorist attacks on the United States on September 11, 2001, however, some Members of Congress are reexamining some elements of this open-door policy and are arguing for greater consideration of the long-term impact of foreign direct investment, especially where that investment takes the form of an acquisition, a merger, or a take-over of an existing U.S. company. In particular, these concerns have centered around the impact of such investments on the structure and the industrial capacity of the economy, and on the ability of the economy to meet the needs of U.S. defense and security interests, including a terrorist attack. As a result of these concerns, in 2007 Congress changed the way foreign direct investments are reviewed through P.L. 110-49, the Foreign Investment and National Security Act of 2007.<sup>2</sup> Through P.L. 110-49, Congress strengthened its role in reviewing foreign investments by enhancing its oversight capabilities. There is no precise way, however, to estimate the exact dollar amount for the economic costs and benefits of national policies that attempt to direct or restrict foreign direct investment for national security concerns. Also, there is no way to determine if foreign investment policies are implemented to enhance national security or to engage in a form of economic protectionism. In some cases, other policy tools may well be preferred to intervening in the foreign investment process.

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<sup>1</sup> CRS Report RL33103, *Foreign Investment in the United States: Major Federal Statutory Restrictions*, by Michael V. Seitzinger.

<sup>2</sup> P.L. 110-49 originated in the first session of the 110<sup>th</sup> Congress as S. 1610, the Foreign Investment and National Security Act of 2007, introduced by Senator Dodd on June 13, 2007. On June 29, 2007, the Senate adopted S. 1610 in lieu of a competing House version, H.R. 556 by unanimous consent. On July 11, 2007, the House accepted the Senate's version of H.R. 556 by a vote of 370-45 and sent the measure to the President, who signed it on July 26, 2007. On January 23, 2008, President Bush issued Executive Order 13456 implementing the law.

## Foreign Direct Investment in the United States

Foreigners invested \$180 billion in U.S. businesses and real estate in 2006 and invested \$237 billion in 2007, according to data published by the Department of Commerce,<sup>3</sup> as **Figure 1** shows. The rise in the value of foreign direct investment includes an upward valuation adjustment of existing investments. According to the Department of Commerce, investment spending through 2007 increased as a result of the relatively stronger growth rate of the U.S. economy, the world-wide resurgence in cross-border merger and acquisition activity, and investment in the U.S. manufacturing, information and depository institutions as overseas banks and finance and insurance companies sought access to the profitable U.S. financial market.<sup>4</sup>

New spending by U.S. firms on businesses and real estate abroad, or U.S. direct investment abroad,<sup>5</sup> rose sharply in 2006 to \$235 billion up from the \$8 billion net in 2005. New investments in 2007 reached \$333 billion, according to balance of payments data published by the Department of Commerce.<sup>6</sup> The drop in U.S. direct investment abroad in 2005 reflects actions by U.S. parent firms to reduce the amount of reinvested earnings going to their foreign affiliates for distribution to the U.S. parent firms in order to take advantage of one-time tax provisions in the American Jobs Creation Act of 2004 (P.L. 108-357).

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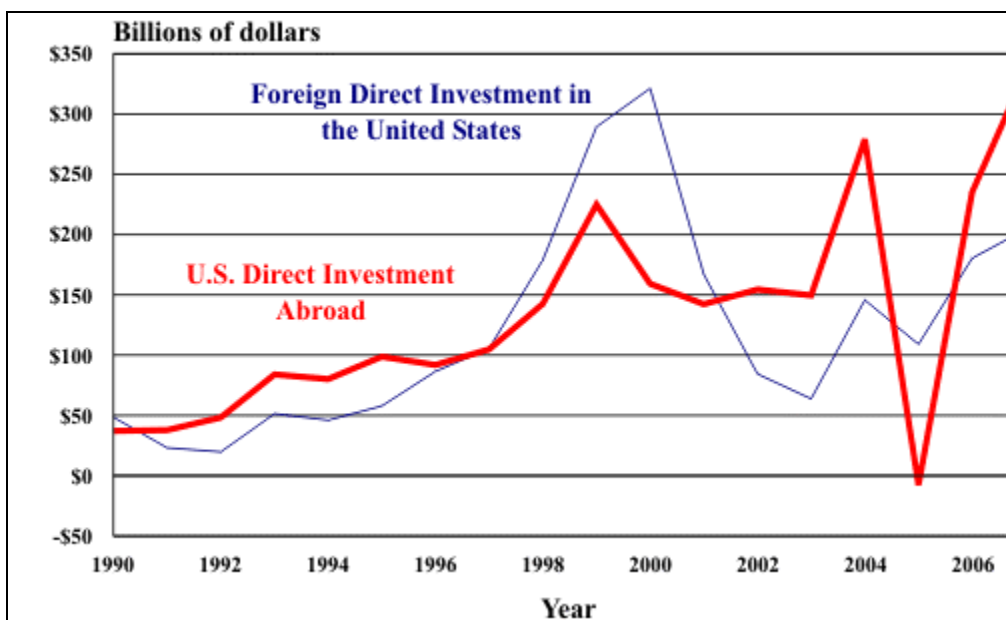
<sup>3</sup> Hoang, Mai-Chi, and Erin M. Whitaker, U.S. International Transactions: Second Quarter of 2008. *Survey of Current Business*, October 2008, p. 74. Direct investment data reported in the balance of payments differ from capital flow data reported elsewhere, because the balance of payments data have not been adjusted for current cost adjustments to earnings.

<sup>4</sup> Ku-Graf, Y. Louise, Foreign Direct Investment in the United States: New Investment in 2007, *Survey of Current Business*, June 2008, p. 33-40.

<sup>5</sup> The United States defines direct investment abroad as the ownership or control, directly or indirectly, by one person (individual, branch, partnership, association, government, etc.) of 10% or more of the voting securities of an incorporated business enterprise or an equivalent interest in an unincorporated business enterprise. 15 CFR § 806.15 (a)(1).

<sup>6</sup> Hoang, Mai-Chi, U.S. International Transactions: Second Quarter of 2008, p. 74.

**Figure 1. Foreign Direct Investment in the United States and U.S. Direct Investment Abroad, Annual Flows, 1990-2007**



**Source:** U.S. Department of Commerce.

**Note:** The drop in U.S. direct investment abroad in 2005 reflects actions by U.S. parent companies to take advantage of a one-time tax provision.

According to the U.N. *World Investment Report*,<sup>7</sup> the largest 100 multinational corporations in the world experienced a stagnation of their sales, employment, and growth in assets from 2000 to 2003, but global foreign direct investment flows picked up in the 2004-2007 period, as indicated in **Table 1**. In 2005, 2006, and 2007 global direct investment flows grew by 27%, 38%, and 18%, respectively, to reach \$1.5 trillion. The rise in global direct investment flows was driven by an increase in corporate profits worldwide and resulting higher stock prices that raised the value of cross-border mergers and acquisitions. The developed economies continue to absorb about two-thirds of global direct investment flows, with the developing economies sharing the rest. Africa continues to receive the smallest share, generally less than 3%, with Latin America receiving about 8% and Asia getting between 18% and 22%. The United Nations estimates that foreign direct investment should remain strong through 2009.<sup>8</sup> A recent study on investment trends by the Organization for Economic Cooperation and Development (OECD) reports that direct investment outflows reached a record \$1.8 trillion in 2007, in part due the decline in the value of the dollar relative to the euro, which results in an upward valuation in dollar terms in investments that originally had been priced in euros. The OECD projects that the overall amount of direct investment flows in 2008 will decline as a result of lower levels of foreign direct investment into and out of the United States.<sup>9</sup>

<sup>7</sup> *World Investment Report 2007*, United Nations, July 2007, p. 5.

<sup>8</sup> *World Investment Prospects Survey: 2007-2009*. United Nations Conference on Trade and Development, 2007.

<sup>9</sup> OECD FDI Outflows and Inflows Reach Record Highs in 2007 But Look Set to Fall in 2008. *OECD Investment News*, June 2008, p. 1.

**Table 1. Global Annual Inflows of Foreign Direct Investment, By Major Area**

(in billions of dollars and percent shares)

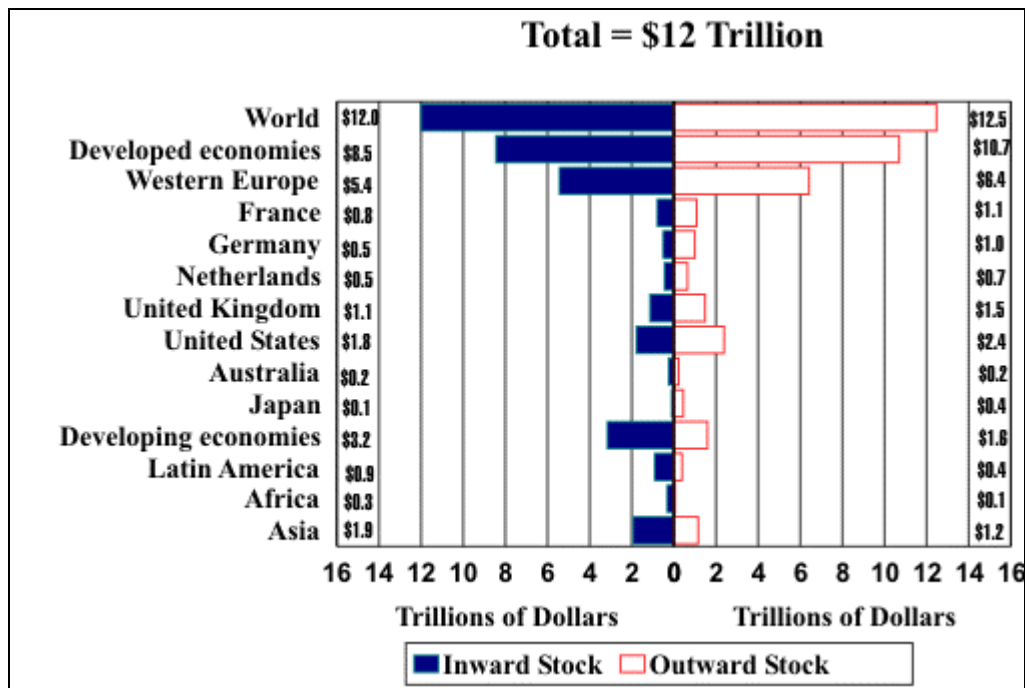
	2005	2006	2007	2005	2006	2007
	Inflows of foreign direct investment (in billions of dollars)			Share of annual foreign direct investment inflows (in percent)		
<b>World</b>	\$945.8	\$1,305.9	\$1,537.9	100.0%	100.0%	100.0%
<b>Developed economies</b>	590.3	857.5	1,001.9	62.4	65.7	65.1
Western Europe	495.0	566.4	651.0	52.3	43.4	42.3
European Union	486.4	531.0	610.0	51.4	40.7	39.7
Other Western Europe	8.6	35.4	38.0	0.9	2.7	2.5
North America	129.9	244.4	n.a.	13.7	18.7	n.a.
United States	101.0	175.4	192.9	10.7	13.4	12.5
Other developed econ.	-34.6	46.7	n.a.	-3.7	3.6	n.a.
<b>Developing economies</b>	314.3	379.1	438.4	33.2	29.0	28.5
Africa	29.6	35.5	35.6	3.1	2.7	2.3
Latin America	75.5	83.7	125.8	8.0	6.4	8.2
Asia	209.1	259.8	277.0	22.1	19.9	18.0
Other Europe	41.2	69.3	97.6	4.4	5.3	6.3

**Source:** *World Investment Report, 2007*, United Nations. Annex table B.1; Foreign Direct Investment Reached New Record in 2007, UNCTAD press release, January 8, 2008.

Globally, the total, or cumulative, amount of foreign direct investment reached \$12 trillion in 2006 (the latest year for which detailed data are available), as indicated in **Figure 2**. Nearly three-fourths of this amount is invested in the most economically-advanced developed economies. The developed economies not only are the greatest recipient of investment funds, but they are also the greatest source of those funds. Similar to the United States, those countries that are the largest overseas investors also tend to be the most attractive destinations for foreign investments. The clear exception to this general observation is Japan, which had invested \$450 billion abroad through 2006, but had received \$107 billion in investment inflows. Among the developing economies, Asia, which includes China, has accumulated \$1.9 trillion in direct investment, followed by Latin America (\$908 billion) and Africa (\$315 billion).



**Figure 2. Inward and Outward Global Direct Investment Position, By Major Area, 2006**



Source: United Nations.

By the end of 2006, there were about 2,300 U.S. parent companies with 25,000 affiliates operating abroad, as **Table 2** indicates. In comparison, foreign firms had about 5,300 affiliates operating in the United States. U.S. parent companies employed nearly 22 million workers in the United States, compared with the 10.9 million workers employed abroad by U.S. firms and the 5.8 million persons employed in the United States by foreign firms. Although the U.S.-based affiliates of foreign firms employ slightly more than half the number of workers as the foreign affiliates of U.S. firms, they paid almost as much in aggregate employee compensation in the United States as did the U.S. affiliates operating abroad. The foreign affiliates of U.S. parent companies, however, had a third higher value of gross product than did the affiliates of foreign firms operating in the United States. In addition, the foreign affiliates of U.S. firms had total sales that were a third higher than that of the U.S. affiliates of foreign firms. The foreign affiliates of U.S. firms, however, paid three times more in taxes to foreign governments than did the affiliates of foreign firms operating in the United States.

**Table 2. Select Data on U.S. Multinational Companies and on Foreign Firms Operating in the United States, 2006**

(in millions of dollars unless otherwise indicated)

	U.S. Multinational Companies		U.S. Affiliates of Foreign Firms
	Parent Companies	Affiliates	
Number of firms	2,278	25,362	5,315

	U.S. Multinational Companies		U.S. Affiliates of Foreign Firms
	Parent Companies	Affiliates	
Employment (thousands)	21,747.6	10,935.4	5,800.6
Employee compensation	\$1,365,399	\$426,207	\$385,818
Gross product	\$2,509,219	\$995,638	\$614,685
Total assets	\$18,520,846	\$11,539,657	\$7,908,487
Sales	\$8,273,414	\$4,731,350	\$3,083,440
Taxes	\$169,959	\$170,482	\$51,516
R&D Expenditures	\$216,297	\$28,484	\$37,773

**Source:** U.S. Direct Investment Abroad: Operations of U.S. Parent Companies and Their Foreign Affiliates, Preliminary 2006 Estimates; and Foreign Direct Investment in the United States: Operations of U.S. Affiliates of Foreign Companies, Preliminary 2006 Estimates.

U.S. multinational companies also play an important role in the U.S. economy. According to the total output of U.S. parent companies, or gross product, they produced \$2.5 trillion in goods and services in 2006, up slightly from the \$2.3 trillion dollars they produced in 2005. This amount comprised about 21% of total U.S. private industry gross product, a share of total gross product of U.S. parent companies that has remained fairly consistent since the early 1990s despite significant changes in the U.S. economy as a whole. The data also demonstrate the impact the improvement in the U.S. economy after 2002 had on the operations of U.S. multinational companies.

## National Security

Since the end of World War II, the United States has led efforts internationally to reduce official government restrictions on foreign investment. One prominent exclusion to these efforts and to commitments incorporated in international treaties is the right of nations to protect their own “essential security interests.” The terrorist attacks of September 11, 2001, combined with the growing role of state-backed investors, or sovereign wealth funds (SWFs),<sup>10</sup> has spurred a number of nations to reconsider their national security interests relative to inward investment and to consider placing additional restrictions on foreign investments in areas considered to be an essential security interest.<sup>11</sup> For the most part, such restrictions apply to mergers, acquisitions, and takeovers of existing firms and not generally to new establishments. These actions, in turn, have raised concerns among the members of such organizations as the OECD,<sup>12</sup> which promotes the concept of liberalized government restrictions on the free flow of international investment.

<sup>10</sup> For additional information, see CRS Report RL34336, *Sovereign Wealth Funds: Background and Policy Issues for Congress*, by Martin A. Weiss.

<sup>11</sup> *World Investment Report*, 2007, p. 14.

<sup>12</sup> For additional information, see CRS Report RS21128, *The Organization for Economic Cooperation and Development*, by James K. Jackson.

## OECD Arrangements

With some exceptions for national security, the United States has long been considered one of the most receptive economies in the world to foreign direct investment. The United States has led efforts to negotiate internationally for reduced restrictions on foreign direct investment, for greater rules on incentives offered to foreign investors, and for equal treatment under law of foreign and domestic investors. In particular, the United States has supported efforts within the OECD to develop such legally non-binding arrangements as the OECD Code of Liberalization of Capital Movements (covering both long-and short-term capital movements) and the Code of Liberalization of Current Invisible Operations (covering cross-border trade in services). In addition, the OECD has issued a basic statement on foreign investment, *The Declaration on International Investment and Multinational Enterprises*, which is a general statement of policy regarding the rights and responsibilities of foreign investors.

The United States and other signatories to the OECD arrangements recognize that one notable exception to the open investment policies provided for in the OECD instruments, as well as in customary international law, is that governments can take measures they “consider necessary to protect essential security interests” and to maintain “public order or the protection of public health, morals, and safety.” Such an exception has been recognized in various international agreements, in countless bilateral investment treaties, and in investment chapters of free trade agreements. According to the OECD, “The right to protect essential security interests of the state, as an exception to treaty commitments, has been well established in treaty practice.”<sup>13</sup>

Another aspect of this policy is that each state is best situated to assess its own security interests and to decide whether essential security interests are at stake relative to certain types of investments. Under customary international law, the argument of necessity has been interpreted to mean an incident that poses a grave and imminent peril to a country, or a threat to such vital interests as, “political or economic survival, the continued functioning of its essential services, the maintenance of internal peace, the survival of a sector of its population, and the preservation of the environment of its territory.”<sup>14</sup> Various agreements, including multilateral agreements and OECD investment instruments, acknowledge that each nation has the exclusive role of determining for itself whether a restriction on foreign investment is necessary to protect its essential security interests.

As governments move to assess their national policies on foreign investments, they are faced with a trade-off between their desires to preserve and expand an open international investment environment with the national responsibility to safeguard essential security interests. This trade-off is complicated further by the nature of the threats that are associated with mergers, acquisitions, and takeovers of existing firms. Such investments generally are not viewed as posing an immediate threat to the stability or security of a nation. Some observers, however, view some of these investments as posing potential threats to the economy in the form of a loss of technology related to national security, a loss of jobs due to outsourcing, or a threat associated with state-backed investors who use their investments to advance political objectives. As a result, policies directed at reviewing foreign direct investments are best described as precautionary

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<sup>13</sup> *International Investment Perspectives: Freedom of Investment in a Changing World*, 207 Edition, Organization for Economic Cooperation and Development, 2007, p. 105.

<sup>14</sup> *Ibid.*, p. 100.

measures.<sup>15</sup> In this report, the national security threats posed by mergers, acquisition, or takeovers do not include overt acts of transnational terrorism that are meant to dissuade foreign capital inflows.<sup>16</sup> The OECD reports that a number of governments have started to review their policies on inward foreign investment in response to a “changing context for national security and the increasing prominence of new investors, including large investors controlled by foreign governments.”<sup>17</sup> From France and Germany, the United States and Canada, to various non-OECD countries, existing regulatory regimes have been used to deter certain investments in infrastructure for national security concerns or countries have tightened their regulations on security grounds.<sup>18</sup>

Due to the increased attention focused on the national security aspects of inward foreign investment, the OECD formed in June 2006 the “Freedom of Investment, National Security and ‘Strategic Industries’” project. Through the eight rounds of meetings, including the latest one held in October 2008, members<sup>19</sup> of the investment project have agreed to support three principles for national investment policy measures that address essential security interests: 1) transparency and predictability;<sup>20</sup> 2) proportionality;<sup>21</sup> and 3) accountability. Proportionality refers to the concept that restrictions on foreign investment should be no greater than is needed to protect national security. In June 2007 at the annual summit of the Group of Eight<sup>22</sup> (G8) leading industrialized nations, the group issued a “Declaration on Freedom of Investment, Environment and Social Responsibility.” The final summit statement also emphasized the group’s continuing support for the OECD project on Freedom of Investment, National Security and “Strategic Industries.” The G8 statement also offered its support for a free flow of investment by indicating that:

We will work together to strengthen open and transparent investment regimes and to fight against tendencies to restrict them. Erecting barriers and supporting protectionism would result in a loss of prosperity. We therefore agree on the central role of free and open markets to facilitate global capital movements. We reaffirm that freedom of investment is a crucial pillar of economic growth, prosperity and employment....Against this background we remain committed to minimize any national restrictions on foreign investment. Such restrictions should apply to very limited cases which primarily concern national security. The general principles to be followed in such cases are non-discrimination, transparency and

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<sup>15</sup> Friedman, Benjamin H., The Terrible ‘Ifs’, *Regulation*, Winter 2007/2008, pp. 32-40.

<sup>16</sup> Enders, Walter and Todd Sandler, Terrorism and Foreign Direct Investment in Spain and Greece, in Sandler, Todd, and Keith Hartley, eds., *The Economics of Conflict*, Vol. II. Cheltenham, UK; Northampton, MA; Edward Elgar, 2003.

<sup>17</sup> *Freedom of Investment, National Security and “Strategic” Industries: Progress Report by the OECD Investment Committee*. Organization for Economic Cooperation and Development, April 2008; *Eighth Roundtable on Freedom of Investment, National Security and “Strategic” Industries*, OECD, October 8, 2008.

<sup>18</sup> *International Investment Perspectives*, p. 55.

<sup>19</sup> The members of the project include the 30 members of the OECD, the 10 non-member adherents to the Declaration (Argentina, Brazil, Chile, Egypt, Estonia, Israel, Latvia, Lithuania, Romania, and Slovenia), Russia, and other countries that attended at least one session: China, India, Indonesia, and South Africa.

<sup>20</sup> *Transparency and Predictability for Investment Policies Addressing National Security Concerns: A Survey of Practices*. Organization for Economic Cooperation and Development, May 2008.

<sup>21</sup> *Proportionality of Security-Related Investment Instruments: A Survey of Practices*. Organization for Economic Cooperation and Development, May 2008.

<sup>22</sup> The Group of Eight nations includes Canada, France, Germany, Italy, Japan, Russia, the United Kingdom, and the United States.

predictability. In any case, restrictive measures should not exceed the necessary scope, intensity and duration.<sup>23</sup>

The OECD project on investment is expected to issue its final report in mid-2009, at which point the project is expected to issue policy guidance in the form of a menu of best practices for the signatories to consider so that as they implement investment policies they do so in a way that is consistent with the three principles. While it is too early to tell, nations, including the United States, may choose to adjust their national laws to have them conform to the recommendations of the OECD's final report. The OECD members also have agreed to adopt a set of 14 guidelines that are meant to serve as the basis for establishing investment policy measures. These guidelines are designed to assist nations in adopting investment measures that safeguard national security and are consistent with the three principles of transparency, proportionality, and accountability. These measures are:

- Non-discrimination: Governments should treat similarly situated foreign and domestic investments in a similar fashion.
- Transparency/Predictability: Regulatory practices should be as transparent as possible while also protecting the confidentiality of sensitive information.
- Codification and publication: Laws, particularly evaluation criteria used in reviews of investment transactions, should be codified and made public.
- Prior notification: Governments should take steps to notify interested parties about plans to change investment policies.
- Consultation: Governments should seek the views of interested parties when they are considering changing investment policies.
- Procedural fairness and predictability: Reviews should have time limits; sensitive information should be protected.
- Disclosure of investment policy actions: Governments should disclose investment policy actions as a measure of accountability.
- Regulatory proportionality: Restrictions should not be greater than needed to protect national security.
- Essential security concerns are self-judging: Countries have the right to determine what is necessary to protect their own national security.
- Narrow focus: Investment restrictions should be narrowly focused on concerns related to national security.
- Appropriate expertise: Measures related to national security concerns should be designed so that they can benefit from national expertise on national security and that it is possible to weigh the benefits of the investment policies against the impact of the restrictions.
- Tailored responses: Investment measures should be tailored to the specific risks posed by specific investment proposals.

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<sup>23</sup> *Growth and Responsibility in the World Economy*, G8 Summit Declaration, June 7, 2007. Paragraphs 10 and 11.

- Last resort: Restrictive investment should be used as a last resort when other policies cannot be used to eliminate security-related concerns.
- Accountability: To ensure accountability by government agencies, investment measures should be reviewed by government oversight, judicial review, periodic regulatory impact assessments, and requirements that decisions to block an investment should be taken at high government levels.

## Critical Infrastructure

As part of the general area of essential security concerns associated with foreign investment, numerous nations have focused on the concept of critical infrastructure as a separate area of concern within the rubric of essential security interests.<sup>24</sup> As **Table 3** indicates, national definitions of critical infrastructure differ among countries, although most of the countries surveyed by the OECD define critical infrastructure as physical infrastructure that provides essential support for economic and social well-being, for public safety, and for the functioning of key government responsibilities. In most cases, the national definitions of critical infrastructure are broad statements that provide national governments with a wide latitude for deciding which assets or sectors to designate as critical. Such definitions implicitly acknowledge the importance that the broader economic and security context plays in determining which sectors might be selected for designation as critical and that this designation may change depending on the circumstances.

**Table 3. Examples of National Definitions of Critical Infrastructure**

Australia	Those physical facilities, supply chains, information technologies and communication networks which, if destroyed, degraded or rendered unavailable for an extended period, would significantly impact on the social or economic well-being of the nation, or affect Australia's ability to conduct national defense and ensure national security.
Canada	Those physical and information technology facilities, networks, services and assets which, if disrupted or destroyed, would have a serious impact on the health, safety, security or economic well-being of Canadians or the effective functioning of governments in Canada.
Germany	Organizations and facilities of major importance to the community whose failure or impairment would cause a sustained shortage of supplies, significant disruptions to public order or other dramatic consequences.
Netherlands	Products, services and the accompanying processes that, in the event of disruption or failure could cause major social disturbance. This could be in the form of tremendous casualties and severe economic damage.
United Kingdom	Those assets, services and systems that support the economic, political and social life of the UK whose importance is such that loss could: 1) cause large-scale loss of life; 2) have a serious impact on the national security; 3) have other grave social consequences for the community; or 4) be of immediate concern to the national government.

<sup>24</sup> *Protection of "Critical Infrastructure" and the Role of Investment Policies Relating to National Security*, The Organization for Economic Cooperation and Development, May 2008, p. 2.

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United States	In the overall U.S. critical infrastructure plan the definition includes systems and assets, whether physical or virtual, so vital to the United States that the incapacity or destruction of such systems and assets would have a debilitating impact on security, national economic security, national public health or safety, or any combination of those matters. For investment policy it is defined as: those systems and assets, whether physical or virtual, so vital to the United States that the incapacity or destruction of such systems and assets would have a debilitating impact on national security.
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**Source:** *Protection of Critical Infrastructure and the Role of Investment Policies Relating to National Security*, The Organization for Economic Cooperation and Development, May 2008.

## Essential Security Exclusions

Members of the OECD and other countries that choose to adhere to the voluntary OECD National Treatment Instrument retain the option to exclude sectors of their economy on the grounds of essential security interests from the national treatment standard. In such cases, nations are using discriminatory practices to restrict foreigners from investing in sectors of their economies that are deemed to be important to national security. In making such exceptions, nations that are parties to the National Treatment Instrument provide a notification to the other members that they are requesting an exemption from the protocol, thereby providing a method to make the process transparent to all the signatories of the Instrument.

According to a recent OECD study, countries that are adhering to the OECD National Treatment Instrument have exempted an extensive array of discriminatory foreign investment policies from the Instrument in order to protect critical infrastructure from foreign investment. For instance, all 39 nations that are a party to the Instrument report that they discriminate against foreign investment in one or more critical infrastructure sectors. Of these sectors, transport is the most targeted sector, with all 39 countries reported having discriminatory measures.<sup>25</sup> Such restrictions generally fall within three categories: 1) blanket restrictions that cover a specific activity; 2) sector-specific restrictions that affect investment in a specific sector of the economy; and 3) measures that apply to a broad range of infrastructure investments and approval procedures that could be used to block infrastructure investments that are deemed to pose threats to essential security interests.

The OECD also concluded that the national restrictions were notably general in their descriptions. In turn, the OECD concluded that the generality of the restrictions is due to four issues: 1) the nature of the security threats may affect perceived threats and vulnerabilities; 2) the assessment of the threats may be affected by the nationality of the foreign investor; 3) some perceived threats may be resolved easily through mitigation efforts, while others may not; and 4) not all countries have the capabilities to conduct in-depth evaluations of potential national security threats. The OECD also concluded that it is difficult to assess the value such restrictions have in enhancing the essential national security of the members. In most cases, such policies are measures of last resort when other national laws or measures are determined to be insufficient, or they can provide a process that assists various agencies within a national government with identifying and dealing with security threats that might be posed by international investment.<sup>26</sup>

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<sup>25</sup> *Protection of Critical Infrastructure and the Role of Investment Policies Relating to National Security*, p. 6.

<sup>26</sup> *Ibid.*, p. 8.

**Table 4. Industrial Sectors Included in National Critical Infrastructure Plans**

Sector	Australia	Canada	Netherlands	United Kingdom	United States	European Union
Energy (including nuclear)	X	X	X	X	X	X
Communications	X		X	X	X	X
Finance	X	X	X	X	X	X
Health care	X	X	X	X	X	X
Food	X	X	X	X	X	X
Water	X	X	X	X	X	X
Transport	X	X	X	X	X	X
Safety	Emergency services	X	X	Emergency services	Emergency services	X
Government		X	X	X	X	X
Chemicals		X	X		X	X
Defense industrial base	X	X	X		X	
Other sectors or activities	Public gatherings, national icons		Legal/ judicial		Dams, commercial facilities, national monuments	Space and research facilities

**Source:** *Protection of Critical Infrastructure and the Role of Investment Policies Relating to National Security*, The Organization for Economic Cooperation and Development, May 2008.

## U.S. Foreign Investment Policy

U.S. policy toward foreign direct investment is based primarily on the conclusion that direct investment benefits both the home and the host country and that the benefits of such investment outweigh the costs. Most economists argue that free and unimpeded international flows of capital, such as direct investment, positively affect both the domestic (home) and foreign (host) economies. The essence of this argument is that for the home country, direct investment abroad benefits individual firms, because firms that invest abroad are better able to exploit their existing competitive advantages and are able to acquire additional skills and advantages. This tends to further enhance the competitive position of these firms both at home and abroad and shifts the composition and distribution of employment within the economy toward the most productive and efficient firms and away from the less productive firms.

As a host country, the United States benefits from inward direct investment because the investment adds permanently to the Nation's capital stock and skill set. Direct investment also brings technological advances, since firms that invest abroad generally possess advanced technology, processes, and other economic advantages. Such investment also boosts capital formation, contributes to a growth in a competitive business environment and to productivity. In



addition, direct investment contributes to international trade and integration into the global trading community, since most firms that invest abroad are established multinational firms.<sup>27</sup>

While U.S. policy toward inward and outward direct investment generally has adhered to the overall objective of treating such investment impartially, there are a number of notable exceptions. These exceptions can be classified as sectoral restrictions that exclude foreign ownership from certain sectors of the economy and approval procedures for mergers, acquisitions, and takeovers of existing U.S. firms that could be used to block infrastructure investments that are deemed to pose threats to essential national security. Foreign investors are constrained by U.S. laws that bars foreign ownership in such industrial sectors as maritime, aircraft, mining, energy, lands, communications, banking, and government contracting.<sup>28</sup> Generally, these sectors were closed to foreign investors to prevent public services and public interest activities from falling under foreign control, primarily for national defense purposes.

## **Exxon-Florio and CFIUS**

The second category of restrictions, characterized by such approval procedures as the Exxon-Florio provision, applies to foreign investment in existing U.S. firms through mergers, acquisitions, or takeovers, but does not apply to foreign investors who establish new businesses. In 1988, Congress approved the Exxon-Florio provision<sup>29</sup> as part of the Omnibus Trade Act.<sup>30</sup> The Exxon-Florio provision grants the President broad discretionary authority to take what action he considers to be “appropriate” to suspend or prohibit proposed or pending foreign acquisitions, mergers, or takeovers “of persons engaged in interstate commerce in the United States” which “threaten to impair the national security.” The Exxon-Florio provision does not define national security, because Congress meant to have the term interpreted broadly. Nevertheless, regulations developed by the Treasury Department to implement the law direct the members of the Committee on Foreign Investment in the United States (CFIUS)<sup>31</sup> to focus their reviews of foreign investments exclusively on those transactions that involve “products or key technologies essential to the U.S. defense industrial base,” and not to consider economic concerns more broadly. CFIUS also indicated that in order to assure an unimpeded inflow of foreign investment it would implement the statute “only insofar as necessary to protect the national security,” and “in a manner fully consistent with the international obligations of the United States.”<sup>32</sup> The Committee is an interagency organization that serves the President in overseeing the national security implications of foreign investment in the economy.

The Exxon-Florio process consists of three different steps for reviewing proposed or pending foreign “mergers, acquisitions, or takeovers” of “persons engaged in interstate commerce in the

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<sup>27</sup> Such linkages appear to be important factors for both developed and developing host countries, see Alfaro, Laura, Areendum Chanda, Sebnem Kalemli-Ozcam, and Selin Sayek, *How Does Foreign Direct Investment Promote Economic Growth? Exploring the Effects of Financial Markets on Linkages*. Working Paper 12522, September 2006, National Bureau of Economic Research.

<sup>28</sup> Seitzinger, *Foreign Investment in the United States: Major Federal Restrictions*.

<sup>29</sup> For additional information, see CRS Report RL33312, *The Exxon-Florio National Security Test for Foreign Investment*, by James K. Jackson.

<sup>30</sup> P.L. 100-418, title V, Subtitle A, Part II, or 50 U.S.C. app 2170.

<sup>31</sup> For additional information, see CRS Report RL33388, *The Committee on Foreign Investment in the United States (CFIUS)*, by James K. Jackson.

<sup>32</sup> Ibid.

United States” to determine if the transaction “threatens to impair the national security.” Such investments often imply a change in ownership and not necessarily a change in the operations of the targeted U.S. company. CFIUS has 30 days to conduct a review, 45 days to conduct an investigation, and then the President has 15 days to make his determination. The President is the only officer with the authority to suspend or prohibit mergers, acquisitions, and takeovers.

Neither Congress nor the Administration have attempted to define the term national security as it appears in the Exxon-Florio statute. Treasury Department officials have indicated, however, that during a review or investigation each member of CFIUS is expected to apply that definition of national security that is consistent with the representative agency’s specific legislative mandate.<sup>33</sup> For instance, over time and through a series of Executive Orders, the Department of Defense has developed the National Industrial Security Program (NISP) through which it has adopted various provisions under the term, “Foreign Ownership, Control, or Influence (FOCI).” These provisions attempt to prevent foreign firms from gaining unauthorized access to “critical technology, classified information, and special classes of classified information” through an acquisition of U.S. firms that it could not gain access through an export control license. This type of review is run independently of and parallel to a CFIUS review.

## **Critical Infrastructure/Key Resources**

Arguably, the events of September 11, 2001, reshaped congressional attitudes toward the Exxon-Florio provision. This change in attitude became apparent in 2006 as a result of the public disclosure that Dubai Ports World<sup>34</sup> was attempting to purchase the British-owned P&O Ports,<sup>35</sup> with operations in various U.S. ports. After the September 11<sup>th</sup> terrorist attacks Congress passed and President Bush signed the USA PATRIOT Act of 2001 (Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism).<sup>36</sup> In this act, Congress provided for special support for “critical industries,” which it defined as:

systems and assets, whether physical or virtual, so vital to the United States that the incapacity or destruction of such systems and assets would have a debilitating impact on security, national economic security, national public health or safety, or any combination of those matters.<sup>37</sup>

This broad definition is enhanced to some degree by other provisions of the act, which specifically identify sectors of the economy that Congress considers to be elements in the critical infrastructure of the nation. These sectors include telecommunications, energy, financial services, water, transportation sectors,<sup>38</sup> and the “cyber and physical infrastructure services critical to maintaining the national defense, continuity of government, economic prosperity, and quality of

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<sup>33</sup> Senate Armed Services Committee, Briefing on the Dubai Ports World Ports Deal, February 23, 2006.

<sup>34</sup> Dubai Ports World was created in November 2005 by integrating Dubai Ports Authority and Dubai Ports International. It is one of the largest commercial port operators in the world with operations in the Middle East, India, Europe, Asia, Latin America, the Caribbean, and North America.

<sup>35</sup> Peninsular and Oriental Steam Company is a leading ports operator and transport company with operations in ports, ferries, and property development. It operates container terminals and logistics operations in over 100 ports and has a presence in 18 countries.

<sup>36</sup> P.L. 107-56, title X, Sec. 1014, October 26, 2001; 42 U.S.C. Sec. 5195c(e).

<sup>37</sup> Ibid.

<sup>38</sup> 42 U.S.C. Sec. 5195c(b)(2).

life in the United States.”<sup>39</sup> The following year, Congress transferred the responsibility for identifying critical infrastructure to the Department of Homeland Security (DHS) through the Homeland Security Act of 2002.<sup>40</sup> In addition, the Homeland Security Act added key resources to the list of critical infrastructure (CI/KR) and defined those resources as: “publicly or privately controlled resources essential to the minimal operations of the economy and government.”<sup>41</sup> Through a series of Directives, the Department of Homeland Security identified 17 sectors<sup>42</sup> of the economy as falling within the definition of critical infrastructure/key resources and assigned primary responsibility for those sectors to various Federal departments and agencies, which are designated as Sector-Specific Agencies (SSAs).<sup>43</sup> On March 3, 2008, Homeland Security Secretary Chertoff signed an internal DHS memo designating Critical Manufacturing as the 18<sup>th</sup> sector on the CI/KR list.

By adopting the terms “critical infrastructure” and “homeland security,” following the events of September 11, 2001, Congress demonstrated that the attacks fundamentally altered the way many policymakers view the concept of national security. As a result, many policymakers have concluded that economic activities are a separately identifiable component of national security. In addition, many policymakers apparently perceive greater risks to the economy arising from foreign investments in which the foreign investor is owned or controlled by foreign governments as a result of the terrorist attacks. The Dubai Ports World case, in particular, demonstrated that there was a difference between the post-September 11 expectations held by many in Congress about the role of foreign investment in the economy and of economic infrastructure issues as a component of national security and the operations of CFIUS. For some Members of Congress, CFIUS seemed to be out of touch with the post-September 11, 2001 view of national security, because it remains founded in the late 1980s orientation of the Exxon-Florio provision, which views national security primarily in terms of national defense and downplays or even excludes a broader notion of economic national security.

## **Foreign Investment and National Security Act of 2007**

In 2007, Congress changed the way foreign direct investments are reviewed through P.L. 110-49, the Foreign Investment and National Security Act of 2007.<sup>44</sup> Through P.L. 110-49, Congress strengthened its role in two fundamental ways. First, Congress enhanced its oversight capabilities by requiring greater reporting to Congress by CFIUS on the Committee’s actions either during or after it completes reviews and investigations and by increasing reporting requirements on CFIUS.

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<sup>39</sup> 42 U.S.C. Sec. 5195c(b)(3).

<sup>40</sup> P.L. 107-296, Sec. 2, November 25, 2002; 6 U.S.C. Sec. 101.

<sup>41</sup> 6 U.S.C. Sec. 101(9).

<sup>42</sup> The original sectors include 1) Agriculture and Food; 2) Defense Industrial Base; 3) Energy; 4) Public Health and Healthcare; 5) National Monuments and Icons; 6) Banking and Finance; 7) Drinking Water and Water Treatment Systems; 8) Chemical; 9) Commercial Facilities; 10) Dams; 11) Emergency Services; 12) Commercial Nuclear Reactors, Materials, and Waste; 13) Information Technology; 14) Telecommunications; 15) Postal and Shipping; 16) Transportation Systems; and 17) Government Facilities.

<sup>43</sup> Sector-Specific Agencies include the Departments of: Agriculture, Defense, Energy, Health and Human Services, Homeland Security, Interior, Treasury, and the Environmental Protection Agency.

<sup>44</sup> P.L. 110-49 originated in the first session of the 110<sup>th</sup> Congress as S. 1610, the Foreign Investment and National Security Act of 2007, introduced by Senator Dodd on June 13, 2007. On June 29, 2007, the Senate adopted S. 1610 in lieu of a competing House version, H.R. 556, by unanimous consent. On July 11, 2007, the House accepted the Senate’s version of H.R. 556 by a vote of 370-45 and sent the measure to the President, who signed it on July 26, 2007. On January 23, 2008, President Bush issued Executive Order 13456 implementing the law.

Second, Congress fundamentally altered the meaning of national security in the Exxon-Florio provision by including critical infrastructure and homeland security as areas of concern comparable to national security. The law also requires the Director of National Intelligence to conduct reviews of any investment that may pose a threat to the national security. The law provides for additional factors the President and CFIUS are required to use in assessing foreign investments, including the implications for the nation's critical infrastructure.

In another change, P.L. 110-49 requires CFIUS to investigate all foreign investment transactions in which the foreign entity is owned or controlled by a foreign government, regardless of the nature of the business. Some foreign investors may well regard this approach as a change in policy by the United States toward foreign investment. Prior to this change, foreign investment transactions were reviewed in a way that presumed that the transactions contributed positively to the economy. Consequently, the burden of proof was on the members of CFIUS to prove during a review that a particular transaction threatened to impair national security. P.L. 110-49, however, shifted the burden onto firms that are owned or controlled by a foreign government to prove that they are not a threat to national security. In any given year, the number of investment transactions in which the foreign investor is associated with a foreign government likely is small compared with the total number of foreign investment transactions. The number of such transactions, however, is growing as some foreign governments experience a surge in their foreign exchange reserves and they establish sovereign wealth funds in order to invest part of their reserve funds abroad in an array of activities, including in U.S. businesses. Many countries, such as China, also have state-owned enterprises that operate in the global economy.

To clarify U.S. policy toward foreign investment after the Dubai Ports World controversy and the impending passage of P.L. 110-49, President Bush released on May 10, 2007, a policy statement on open economies.<sup>45</sup> The statement offered strong support for the international flow of direct investment. In part, the statement reads:

A free and open international investment regime is vital for a stable and growing economy, both here at home and throughout the world. The threat of global terrorism and other national security challenges have caused the United States and other countries to focus more intently on the national security dimensions of foreign investment. While my Administration will continue to take every necessary step to protect national security, my Administration recognizes that our prosperity and security are founded on our country's openness.

As both the world's largest investor and the world's largest recipient of investment, the United States has a key stake in promoting an open investment regime. The United States unequivocally supports international investment in this country and is equally committed to securing fair, equitable, and nondiscriminatory treatment for U.S. investors abroad. Both inbound and outbound investment benefit our country by stimulating growth, creating jobs, enhancing productivity, and fostering competitiveness that allows our companies and their workers to prosper at home and in international markets. My Administration is committed to ensuring that the United States continues to be the most attractive place in the world to invest. I urge other nations to join us in supporting an open investment policy and protecting international investments.

The CFIUS process is just one of three major provisions of law that authorize the review of foreign direct investment transactions in the United States for their impact on the economy. The

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<sup>45</sup> President Bush's statement is available at <http://www.whitehouse.gov/news/releases/2007/05/20070510-3.html>

National Industrial Security Program and the critical industries provisions of various statutes also require that foreign direct investment transactions be reviewed. Generally, the reviews mandated by these three provisions operate independently, although at times they have overlapped. The provisions illustrate the complexities involved in defining most economic activities, which can span a broad range of economic activities and fields. Most economic activities affect various sectors and segments of the economy in ways that defy a narrow definition and complicate efforts to distinguish those economic activities that are related to the broad rubric of national security or to national economic security, which is even less clearly defined.

## **Strategic Materials Protection Board**

The Strategic Materials Protection Board, created in 2006, could restrict other types of foreign investment transactions, although this likely will affect a small group of such transactions. In retrospect, some observers hope this provision will prevent future transactions similar to the 2005 merger between Magnequench International and the Canadian-owned firm AMR Technologies, Inc., which shifted ownership of the world's largest producer of Neo powder (composed of neodymium, iron, and boron) to produce Neo magnets.<sup>46</sup> The Strategic Materials Protection Board was mandated by Title VIII of the John Warner National Defense Authorization Act for Fiscal Year 2007, signed October 17, 2006 and designated as P.L. 109-364. The act established that the Strategic Materials Protection Board would be composed of representatives from: the Secretary of Defense; the Under Secretary of Defense for Acquisition, Technology, and Logistics; the Under Secretary of Defense for Intelligence; the Secretary of the Army; the Secretary of the Navy; and the Secretary of the Air Force. The Board is required to meet at least once every two years to make recommendations regarding materials critical to national security and to report to Congress on the results of meetings and on the recommendations of the Board. In addition, the act prohibits the Department of Defense from buying "strategic materials critical to national security" unless the metals are reprocessed, reused, or produced in the United States, except under a number of conditions, including the lack of availability of specialty metals.

The Board is directed in the statute to undertake four activities:

1. Determine the need to provide a long term domestic supply of materials designated as critical to national security to ensure that national defense needs are met.
2. Analyze the risk associated with each material designated as critical to national security and the effect on national defense that the non-availability of such material from a domestic source would have.
3. Recommend a strategy to the President to ensure the domestic availability of materials designated as critical to national security.
4. Recommend such other strategies to the President as the board considers appropriate to strengthen the industrial base with respect to materials critical to national security.

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<sup>46</sup> Neo magnets have a broad range of uses in products where strong magnetic properties are required in conjunction with small size and weight, including hard disk drives, optical disk drives, printers, faxes, scanners, camcorders, game consoles, pagers, PDA's, mobile phones, mp3 players, video recorders, transmission speed sensors in automobiles, airbag sensors, instrument gauges, bearings, generators, cordless power tools, refrigerators, air conditioners, and such military applications as magnets in the motors of the U.S. Joint Direct Attack Munition, or smart bombs.

The Strategic Materials Protection Board met on July 17, 2007, and published a report in September 2007 of that meeting. At that meeting, the Board determined that the term “materials critical to national security” would mean “strategic materials critical to national security” as specified in the statute and would include those metals listed in Section 842 of P.L. 109-364 (10 U.S.C. 2533b). In this section, specialty metals are defined as:

1. Steel
  - A) with a maximum alloy content exceeding one of more of the following limits” manganese, 1.65 percent, silicon, 0.60; or copper, 0.60 percent, or
  - B) containing more than 0.25 percent of any of the following elements; aluminum, chromium, cobalt, columbium, molybdenum, nickel, titanium, tungsten, or vanadium.
2. Metal alloys consisting of nickel, iron-nickel, and cobalt base alloys containing a total of other alloying metals (except iron) in excess of 10 percent.
3. Titanium and titanium alloys.
4. Zirconium and zirconium base alloys.

## **Economic Considerations**

The growing prominence of national security issues in the development of national foreign investment policies is raising questions about how policymakers can evaluate the economic costs and benefits of such measures when the measures are designed to restrict mergers, acquisitions, and take-overs of domestic firms by foreign investors for national security reasons. Indeed, such measures can sometimes focus more on achieving non-economic objectives than on achieving economic efficiency or on supporting a market-based allocation of resources. In addition, such policies often expose differing political and philosophical differences between policymakers within countries and among countries. Within the United States, for instance, such differences exist among Members of Congress and between Congress and the Administration over the role foreign investment should play in the economy. This analysis becomes especially complicated, because each nation has the authority to define its essential security concerns on its own terms and to adjust its foreign investment policy to meet that definition. As a result, such policies defy a straightforward cost-benefit analysis and can mask economic protectionism. This section discusses one possible framework for assessing the economic impact of more restrictive investment policies.

Part of the difficulty involved in assessing the economic impact is that at present there is no working set of parameters that establishes a functional definition of the national security implications of such economic activities as mergers, acquisitions, or take-overs of existing U.S. firms by foreign investors. This process of evaluation is even more difficult in peace time when there is no immediate national security threat posed by foreign investment that dictates the course of national security policies. In most cases, government actions to stop or curtail foreign direct investment in the form of a merger, an acquisition, or a take-over of an existing U.S. firm are mainly precautionary measures aimed at addressing potential future actions that a foreign investor may take.<sup>47</sup> This process of identification is also complicated on a multi-lateral basis, because

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<sup>47</sup> *International Investment Perspectives*, p. 54-63.

each nation has its own definition of national security and its own approach to formulating policies regarding the role of economic activity within the national security rubric.

Whether intended or not, intervention in the economy on national security grounds creates a mix of industrial activities that most likely would not be achieved through traditional economic market forces. Such intervention often is associated with three types of economic activity. First, the intervention may involve efforts to prevent foreign firms from acquiring certain U.S. firms as a result of the type of economic activity that characterizes the U.S. firm or is related to the nature of the output produced by the U.S. firm. Second, opposition on national security grounds may arise as a result of concerns over the country of origin of the foreign acquirer. This type of concern has grown over the recent past because of the growing role of sovereign wealth funds controlled by foreign governments.

Third, national policies may provide special consideration for certain economic activities in the form of economic incentives for U.S. firms or barriers against foreign acquisition due to a belief that the targeted economic activities are important to national security. In some cases, intervention in the foreign investment process may be justified on a combination of economic and non-economic arguments. In these cases, the economic costs and benefits that accrue to the economy as a result of the policy actions may be tied directly to an assessment of the particular set of circumstances within which the cost-benefit analysis is conducted.

In the standard textbook presentation, economic production arises from a combination of the four main types of resources, or factors of production, namely: land, labor, capital, and entrepreneurial ability. Of these four factors, labor and capital are generally singled out due to their overwhelming importance in the production process. Growth within an economy, then, is generally believed to arise from growth in the two main factors of production, capital and labor, which are considered to be fixed at any particular point in time. Over time, however, the rate of growth in the labor force combined with the rate of growth in capital accumulation, or in the way in which capital is used, generally referred to as the rate of growth in productivity, set limits on the rate at which the economy can grow.

In a dynamic economy such as that of the United States, some sectors are expanding, or growing, at a rate that is faster than the economy as a whole, while other sectors are either declining, or are growing at a rate that is slower than the economy as a whole. Since the growth rate in the economy is governed by the rate of growth in the labor force and in productivity, any sector of the economy that grows faster than the average rate for the economy as a whole, can only do so by absorbing capital and labor from other sectors of the economy that, then, must be declining or growing at a rate that is less than the average for the economy as a whole, assuming that the economy is growing at close to full employment. Over time, the growing sectors of the economy necessarily take away capital and labor from the declining sectors of the economy. In the short-run, this transformative process may be uneven and may well lead to a mismatch in skills between sectors, which likely would result in some unused or underutilized resources.

Within the economy, economic theory maintains that demand and supply forces determine the market prices for labor and for capital as the various sectors compete for these scarce resources. These market prices, then, work to allocate resources within the economy among the vast array of economic activities into those activities that use the resources in the most efficient manner. Interference in this process, regardless of the reason, can cause a misallocation of resources in the economy and a loss of efficiency, which imposes a cost on the economy as a whole. In the case of government incentives, or subsidies, for a favored industry, the cost to the economy arises from

two sources. The first is the direct cost involved in shifting resources into the protected sectors of the economy that are at variance with the way in which market forces would allocate those resources.

The second cost is the indirect cost that arises from the benefits that are lost to the economy from preventing resources, particularly foreign capital, from shifting into those sectors that would be gaining resources through market forces, or the opportunity cost to the economy that arises from a misallocation of resources. While mergers, acquisitions, or takeovers of existing U.S. firms by foreign investors imply at least a change in ownership, foreign investors may well possess additional technology, or other advantages that have made them successful international competitors that would be lost if such an investment were prevented for national security reasons. Economists argue that both direct and indirect costs arise when national policies are used to intervene in the foreign investment process, because such intervention generally is contrary to market forces which act to maximize production efficiencies.

Government policies that attempt to enhance national security by restricting acquisitions, mergers, and take-over of existing U.S. firms by foreign investors may also alter the allocation of capital within the economy and, thereby, incur short-term and long-term costs to the economy. For purposes of analysis, economists often divide production and other economic activities into two time periods: the short run and the long run. The distinction between the short run and the long run is not absolute, but is based on the ability of the economy to shift resources among sectors based on market forces. Generally, labor is thought to be the most mobile factor of production that can be shifted relatively quickly among sectors within the economy and at a lower short-run cost than capital. On the other hand, capital is generally thought of as comparatively more difficult to shift among economic sectors over the short-run. For instance, workers can shift into and out of jobs in response to market demand while it is difficult to shift production facilities or buildings from one locale to another. As a result, in the short run, labor is thought of as the variable factor of production, while capital is thought of as a fixed factor of production. In the long-run, however, all factors are viewed as variable since all of the factors can be reallocated to other sectors of the economy in response to shifts in long-term market forces. This division between the short run and the long run simply means that under normal market conditions, the costs of reallocating resources within the economy through public policy measures, or preventing the allocation of capital into certain sectors through foreign investment, that are not in tandem with market forces would accrue high short-run economic costs that would need an equally high combination of short-run and long-run benefits in order to justify the costs to the economy.

The distinction between the short-run and the long-run can change, depending on conditions within the economy that may require a shift in capital and labor among sectors of the economy. For instance, after the United States entered World War II, the U.S. economy shifted from a peace-time consumer-oriented economy to a war-time arms-producing economy within a relatively short period of time, because the external threats to the country were so great that a dramatic shift in the industrial mix of the economy was considered to be a necessary short-run cost that justified overriding market forces in order to produce quickly the material necessary to defend the nation. In this case, the benefits to the economy in terms of added security, principally the ability to defend the country from invasion or destruction, outweighed the short-run and long-run costs to the economy in terms of shifting resources into sectors of the economy that would not have been given priority under peace-time conditions.

In peace-time, without an imminent external threat, it is difficult to determine the economic parameters that define the terms “critical infrastructure,” “homeland security,” and “key



resources.” In addition, it is difficult to define clearly what role foreign investment should play as a separately definable component of national security. This is particularly true in the case of an individual economic transaction such as the acquisition of U.S. firm by a foreign firm. In these cases, the threats to the country often are not well defined or understood and it often is not an easy proposition to evaluate the costs and benefits to the economy as a whole of protecting or promoting certain economic activities. Similarly, it is often difficult to determine the national security elements of allowing or barring investors who are of certain foreign nationalities from acquiring U.S. firms. This problem is compounded under the current “War on Terrorism” in which potential threats to the United States may be decentralized and originate in sub-national organizations.

When policymakers decide to promote certain types of economic activities or to protect U.S. firms or economic activities from foreign investment on the grounds of national security, those officials are in effect weighing the costs and benefits to the nation, or more specifically the marginal costs and marginal benefits, of intervening to alter the mix of industrial activity in the economy. The costs in this case would include the direct short-run and long-run marginal costs associated with blocking foreign capital from being invested in certain favored sectors of the economy in contravention of market forces and, in the case of incentives for favored industries, the indirect costs involved in reducing the available capital and labor that could be used in the economy for more productive activities, or the opportunity cost of the labor and capital.

The marginal benefits that accrue to the nation from such policy activities arise from a combination of a number of factors. The nation may well benefit from the perceived gain in national security and the economy may gain through the capital inflow that is represented by the foreign investment in the form of a merger, acquisition, or take-over of an existing U.S. firm. Foreign investors may also benefit the economy by bringing technological or other production advantages to the United States. Foreign investment may also benefit the economy by sustaining jobs and by producing actual goods and services. These benefits may also include what may be termed the “national security” component of production, or that part of production that satisfies national security concerns. Presumably, the economic benefits would need to be at least as great as the non-economic benefits in order for national policymakers to justify the economic costs. If non-economic benefits comprise the largest share of the expected benefits that arise from the policy action, such a policy course might be economic protectionism in the guise of national security and policymakers may realize greater benefits for the nation by pursuing a different policy course that accrues fewer economic costs.

In addition, the economic and non-economic benefits that are associated with a particular policy may accrue to a large contingent within the economy, as would be the case in a national emergency, or they may accrue to a few as is often the case with economic protectionism. While this distinction between the dispersion of beneficiaries and the allocation of the benefits within the economy is not an absolute way of evaluating national investment policies, it does provide one measure for assessing the distinction between measures that accrue high economic costs relative to few economic benefits within the economy as a whole and may argue in favor of pursuing a different policy course. In some cases the citizens of a nation may be willing to absorb high short-run and long-run costs in order to achieve some non-economic national security goal that benefits a small contingent within the economy. In such a case, however, it may be possible to achieve such a national security goal through means other than through foreign investment policies that entail lower costs for the economy.

The national security component of production may also be equated with a non-economic good that satisfies a national or social objective related to some public assessment of national security. The basis for such non-economic national security benefits can be thought of as a spectrum of benefits that are associated with a similar spectrum of national security threats. These threats can then be thought of as running from threats of imminent destruction that would affect the economy as a whole to concerns about potential activities that are at best tangentially associated with national security and that affect a narrow set of workers and a limited amount of capital. As a result of this spectrum of potential versus real threats and the dangers the threats pose to the economy, the benefits associated with policies that are advanced on the grounds of national security will be stronger or weaker depending on the context within which the argument is made.

Regardless of the nature of the national security threat, the direct and indirect costs to the economy that arise from intervention in the investment process may be the same and pose costs to the economy. Since the costs to the economy that arise from intervention likely are the same, the key to public policy choices is the perceived benefits that are associated with satisfying or addressing such national security concerns. In this way, the marginal costs associated with intervention are equivalent to the marginal benefits that are derived from the policy actions and may be thought of as the cost of satisfying such national security concerns. In the time of full-scale war, the costs to the country of intervening in the economy to redirect resources to produce defense and war material are justified on the basis of the obvious benefits that arise from national survival. In less dire circumstances, however, such cost-benefit comparisons are a great deal more difficult to make.

## Conclusions

Following the terrorist attacks of September 11, 2001, policymakers in the United States and abroad have increased their scrutiny of foreign investment in their economies as a component of national security. There is no precise way, however, to estimate the exact dollar amount for the economic costs and benefits of national policies that attempt to direct or restrict foreign direct investment for national security concerns. Also, it can be difficult to determine if foreign investment policies ultimately result in enhanced national security or are a form of economic protectionism. In concept, the economic costs and benefits associated with restrictive foreign investment policies can be evaluated to determine the overall impact of such policies on the long-run economic performance of country. Evaluating and assessing the national security importance of such policies is complicated, however, because any such assessment naturally occurs within the context with which the assessment takes place. A nation facing an imminent threat of destruction or annihilation is willing to accept extraordinarily high economic costs in order to address such a danger.

Within the United States, the proposed acquisition of P&O Ports by Dubai Ports World in 2006 and the growing presence of investors that are owned or controlled by foreign governments has sparked a debate between Members of Congress and the Administration over the role of foreign investment in the economy. Part of this debate is focused on determining a working set of parameters that establish a functional definition of the national security implications of foreign direct investment. In part, this issue reflects differing assessments of the economic impact of foreign investment on the economy and differing political and philosophical views among Members of Congress and between the Congress and the Administration.

Since 2006, the United States has participated in discussions spearheaded by the OECD to develop a set of best practices to serve as guidelines for national policies that restrict foreign investment for national security objectives. Presently, the participants have agreed that each nation is its own best judge of its national security interests. At the same time, they have agreed that national policies that restrict foreign investment for national security reasons should be transparent, predictable, and non-discriminatory. The final OECD report is scheduled for release in May 2009 and likely will contain a set of best practices that Members of Congress may opt to review as a guide concerning U.S. laws and regulations that govern the U.S. treatment of foreign investment relative to U.S. national security objectives.

There are a number of factors that complicate efforts to assess the impact of policies that restrict foreign investment for national security concerns. Some of those factors include the difficulties that are involved in attaching a precise dollar amount to the economic costs and benefits that are associated with such foreign investment policies. One possible framework for assessing such policies is based on the concept of marginal costs and benefits to the nation that accrue from policies that restrict foreign investment. In this case the benefits are some combination of the economic and non-economic benefits that might be expected to arise from the restrictions, while the costs include a set of real costs that the economy would be expected to incur as a result of the policies. Measures that restrict foreign direct investment that are based on expectations of achieving large non-economic benefits relative to economic benefits and to large economic costs may not be an effective tool. Instead, there may be other policy tools that could be utilized to achieve the same goal, but with lower costs to the economy.

While not determinative, another way of assessing such restrictions is by examining the dispersion of the benefits throughout the economy. At times a nation may well be willing to absorb the high costs that could be involved in protecting some economic activities by restricting or controlling foreign investment. Generally, though it seems reasonable to assume that a policy that is implemented in order to restrict foreign investment that offers benefits to a small group of individuals within the economy and that entails high economic costs relative to benefits, especially where non-economic benefits are a large share of the expected benefits, could be replaced by other measures that accrue lower costs to the economy.

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